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SIPDIS

TREASURY FOR JROSE AND CPLANTIER

SENSITIVE
SIPDIS

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TAGS: EFIN ECON PGOV TU
SUBJECT: Fiscal Discipline in an Election Year

¶1. (SBU) Summary: Turkey's 2007 budget calls for total expenditures of $137 billion; 32% of projected 2007 GDP and 18% higher than in ¶2006. Despite the sharp election-year spending increase, the Government will maintain Turkey's austere 6.5% of GDP primary surplus target, if necessary by means of increased taxes. The above-inflation increase in spending makes it that much harder to achieve the inflation target, putting additional pressure on the Central Bank to keep monetary policy tight. Questions remain about how the GOT will achieve a 20% increase in tax revenues and about social security and state enterprise losses. The big picture, however, is that the Government has opted to stick with a tight primary surplus target in an election year. End Summary.

Primary Surplus Target Retained Despite Spending Surge

¶2. (SBU) The Government announced the broad lines of the budget late on October 17. At YTL 204.9 billion ($136.6 billion), total expenditure came out at 32% of the 2007 GNP target of $404 billion, a nominal increase of 18% over 2006 spending. The budget projects revenues at YTL 188.2 billion ($125.5 billion) and a budget deficit of YTL 16.7 billion ($11.1 billion); 2.7% of the 2007 GNP target of $404.0 billion. As they did last year, Government ministers make much of the fact that this budget deficit is within the Eurozone's Mastricht criteria limit of 3%. Given that Turkey's budget deficit used to be well over 10%, the modest size of the deficit is a significant achievement. Tax revenues are set at YTL 158.2 billion and non-tax revenues, which also include privatization revenues, are set at YTL 29 billion. The primary surplus is targeted at YTL 36.2 billion. Despite the higher spending, the budget retains Turkey's world-beating 6.5% primary surplus target, continuing the centerpiece of its macroeconomic strategy.

IMF Concerns

¶3. (SBU) Earlier reports suggested that the total budget expenditure would be YTL 207 billion ($138 billion) but the IMF mission apparently pressed the Government to reduce the deficit by an extra 6 billion YTL: roughly YTL 2 billion from the expenditure side and 4 billion YTL from the revenue side. The IMF reacted to the Government's plan to increase spending by 20% from YTL 174.3 billion ($120 billion) in the 2006 budget. The IMF's push for a tighter budget stemmed from concerns about increasing health spending, above-inflation civil servant wage hikes, and the likelihood that 2007 interest rates will be higher than previously thought. Despite the squeezing from the IMF, non-interest expenditures increased 19%, far above the rate of increase projected for nominal GDP.

Ambitious Revenue Target

¶4. (SBU) Hitting the primary surplus target in 2007 might be difficult given the ambitious projection for tax collections - a 20% increase over 2006. A portion of the increase is expected to come from more effective tax collections following the restructuring of the Tax Administration. For the first time, the IMF tax experts had enough confidence in the changes at the Tax Administration to build increased tax collection rates into the budget projections. Improved collections are unlikely to be sufficient, however, and many analysts and tax experts believe higher taxes will be required. Speculation centers on an increase in tobacco excise taxes, despite Finance Minister Unakitan's earlier denials that there would be further tax hikes.

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Questions about Social Security, Health and SEEs
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¶5. (SBU) Other unresolved questions relate to the social security system and state enterprises. The reason social security transfers did not surpass the 2006 Budget limit was because of a one-time social security (SS) debt restructuring made in 2006, which brought in revenues from one-off, up-front payments. In 2007, the GOT will have to increase the SS transfers to YTL 32 billion, and may need to compensate for slippage from 2006 in public health expenditures. Additionally, there are likely to be budgetary costs from State Economic Enterprises (SEE), particularly in the electricity and gas sectors. The GOT will eventually have to pass on incurred losses through price hikes to consumers, though it may try to postpone as many of these increases as possible until after the elections.

Wage Hikes Undermine Disinflation Efforts

¶6. (SBU) Taking into account the Government's above-inflation wage settlement with the civil service unions, personnel costs are projected to jump 21% in nominal terms. The generous wage settlement will make it that much harder to achieve the inflation target, putting more of the burden on monetary policy than in previous years. Analysts have concluded that because of the wage increases, the Central Bank will adopt a more cautious stance, waiting longer before resuming interest rate cuts.

¶7. (SBU) Interest expenditures constitute 25% of the total expenditures of YTL 204.9 billion, i.e. YTL 52.9 billion or a 14% increase in nominal terms. Transfers, especially to the social security system and farmers, are also up sharply. Along with its budget presentation, the GOT also announced that per capita GDP would reach $5,472, the GDP growth rate target is 5% and the inflation target is 4% for next year. Export and Imports are foreseen to reach $90 billion and $145 billion respectively.

Cutback in Public Investment

¶8. (SBU) In order to achieve the primary surplus target while accommodating higher wage and social security costs, the Government had to tighten its belt on investment spending, despite the election year and despite the draconian investment budgets of the immediate post-crisis period in 2002 and 2003. At YTL 12 billion, the 2007 investment budget is slightly lower than the 2006 investment budget, even in nominal terms. Press reports suggest the transportation component will be hard hit, with reports of a 27% decline in real terms in transportation spending. The Government will have to slow down progress on some of its signature, high-profile transportation infrastructure projects, such as the Istanbul-Ankara high speed train project, or the large number of highway projects. Press reports suggest the transportation component will be hardest hit, with reports of a 27% decline in real terms in transportation

spending.

Comment

¶9. (SBU) In a recent meeting, Treasury Under Secretary Ibrahim Canakci had warned us to expect a tight budget year. The budget numbers, as well as the last-minute IMF-induced tightening show the tension between the Government's desire to deliver benefits to voters in an election year and its desire to show investors it is sticking with its fiscally-austere economic program. In the end, however, the Government opted to retain the 6.5% target, even if it meant cutting investment spending and possibly raising electricity and gas prices in an election year. When forced to choose between populist electioneering and retaining the confidence of the IMF and investors, the Government chose the latter.

WILSON